

Third Circuit Rules Secured Creditors Do Not Have a Right as a Matter of Law to Credit Bid in Bankruptcy Plan Sale

This week, in a 2-1 decision affirming the District Court’s reversal of a ruling of the Bankruptcy Court for the Eastern District of Pennsylvania, the United States Court of Appeals for the Third Circuit held that secured creditors do not have a right as a matter of law to credit bid their claim at an auction pursuant to a plan of reorganization where the debtor intends to impose the plan on its secured creditors through a “cramdown” under section 1129(b)(2)(A)(iii) of the Bankruptcy Code; *i.e.*, a plan providing the secured creditors with the “indubitable equivalent” of their secured claim. *In re Philadelphia Newspapers, LLC*, 2010 WL 1006647 (3d Cir. March 22, 2010). Circuit Judge Ambro, who was a bankruptcy attorney prior to joining the bench, issued a lengthy dissent.

On August 20, 2009, the debtors proposed a plan of reorganization that contemplates an auction to sell substantially all of the debtors’ assets and provides a recovery to the secured lenders of an estimated \$37 million in cash, which may increase based on the results of the auction, plus \$29.5 million in real estate. The secured lenders are owed approximately \$318 million by the debtors, secured by a first priority lien on substantially all of the debtors’ assets. The debtors anticipate confirmation of the plan by “cramdown” over the expected rejection by the secured lenders by providing the secured lenders with the “indubitable equivalent” of their secured claims. The debtors sought approval of bidding procedures in connection with the auction requiring bids for the assets to be in cash and prohibiting the secured lenders from credit bidding their secured claims. The secured lenders objected to the prohibition on credit bidding.

Section 1129(b) of the Bankruptcy Code establishes circumstances in which a Chapter 11 plan may be confirmed when an impaired class of secured creditors has voted to reject the plan over the objection of such creditors; *i.e.*, a “cramdown.” Section 1129(b)(1) requires that the plan be “fair and equitable” with respect to secured creditors. Section 1129(b)(2)(A) provides three circumstances under which a plan is “fair and equitable” to secured creditors:

- i. the creditors retain their liens on the collateral and receive deferred payments totaling at least the value of their interest in the collateral;
- ii. in the event of a sale of encumbered property, the applicable creditors’ liens attach to the proceeds of such sale, so long as the secured creditors are permitted to credit bid (as provided in section 363(k))¹; or
- iii. the creditors otherwise receive the “indubitable equivalent” of their claims.

¹ Section 363(k) of the Bankruptcy Code provides that “At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.”

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Applying the “plain meaning” rule of statutory construction, the Third Circuit found that the language of section 1129(b)(2)(A) is unambiguous. Subsections (i), (ii), and (iii) must be read in the disjunctive and the use of the word “or” allows a debtor to proceed under any of the three alternatives in the context of a plan sale. The Third Circuit also found that although subsection (ii) specifically refers to a sale and the right to credit bid under section 363(k), a debtor is not restricted to selling its assets in a plan under such subsection.

Thus, the Third Circuit held that a plan which involves a sale of assets may be “fair and equitable” with respect to secured creditors if secured creditors receive the “indubitable equivalent” of their claim under subsection (iii), and that this does not require, as a matter of law, giving the secured creditors the right to credit bid. The Third Circuit pointed out that subsection (iii) contains no reference to the right to credit bidding under section 363(k). A plain reading of the statute therefore led the Third Circuit to the conclusion that where a debtor proceeds under subsection (iii) and will seek to provide a secured creditor with the “indubitable equivalent” of its claim, that creditor does not have the right to credit bid at a sale of the collateral securing its claim. Notably, the Third Circuit made clear that it was not determining whether or not the “indubitable equivalent” was in fact satisfied by the plan, but simply determining whether, as a matter of law, the secured creditor had a right to credit bid under subsection (iii). As the Third Circuit stated, the bankruptcy court will still have to determine at the plan confirmation hearing whether the secured lenders have received the “indubitable equivalent” of their claim under the plan, and the secured creditors can argue, “if appropriate, that the restriction on credit bidding failed to generate fair market value at the [a]uction, thereby preventing them from receiving the indubitable equivalent of their claims.”

The Third Circuit also rejected the notion that its plain language analysis of section 1129(b)(2)(A) is inconsistent with Congressional intent. The secured lenders argued that to protect the interests of undersecured creditors in their collateral, Congress afforded undersecured lenders either the right to “credit bid” under section 363(k) of the Bankruptcy Code or the right to elect to treat their deficiency claims as secured under section 1111(b) of the Bankruptcy Code². Because section 1111(b) precludes creditors from making this election in connection with the sale of their collateral under section 363(b) or under a plan of reorganization, the secured lenders argued that Congress intended that any sale of

collateral would permit credit bidding under section 363(k). The Third Circuit rejected this argument as inconsistent with the plain language and operation of the Bankruptcy Code.

The *Philadelphia Newspapers* decision follows and frequently cites to a recent similar Fifth Circuit opinion, *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009). In *Pacific Lumber*, the Fifth Circuit affirmed the bankruptcy court’s confirmation of a plan of reorganization over the objection of secured noteholders. Confirmation of the plan was sought under section 1129(b)(2)(A)(iii) of the Bankruptcy Code, seeking to cram down the noteholders by providing them with the “indubitable equivalent” of their claims without providing them with a right to credit bid for their collateral at a private sale. The value of the collateral was determined by the bankruptcy court after a lengthy trial and under the plan, the noteholders, who were owed approximately \$714 million, were paid cash in the full amount of the value of their collateral, \$513.6 million. The Fifth Circuit found that, because the confirmation of the plan was sought under section 1129(b)(2)(A)(iii) by providing secured creditors with the “indubitable equivalent” of their claims, *i.e.* cash in the full amount of the collateral value, the noteholders did not have a right to credit bid at the sale.

Third Circuit Judge Ambro wrote a lengthy dissent in *Philadelphia Newspapers*. Applying canons of statutory interpretation, examining the context of related statutory provisions and looking to legislative history, Judge Ambro concluded that a sale free and clear of liens pursuant to a cramdown plan of reorganization falls within the specific requirements of a right to “credit bid” of section 1129(b)(2)(A)(ii) and not the general “indubitable equivalent” requirement of subsection (iii).

Judge Ambro concluded that section 1129(b)(2)(A) has more than one plausible interpretation, indicating that the provision is ambiguous. The “longer-lived” interpretation of section 1129(b)(2)(A), to which the dissent subscribes, is that subsections (i), (ii), and (iii) are not alternatives to cramdown confirmation, but specific requirements depending on how the plan proposes to treat secured creditor claims. Therefore, subsection (ii), the only provision that mentions a sale, is the only provision applicable to plan sales free of liens.

The full impact of *Philadelphia Newspapers* and *Pacific Lumber* will not be known until bankruptcy courts and practitioners have had time to adapt to the decisions. Certainly in jurisdictions within

² Section 1111(b) of the Bankruptcy Code allows nonrecourse undersecured creditors to elect to have their deficiency claims treated as fully secured claims. A nonrecourse creditor who makes this election would be permitted to treat its deficiency claim as secured.

the Fifth and Third circuits, including the popular bankruptcy venue of Delaware, secured creditors no longer have an absolute right to credit bid at a sale conducted under a “cramdown” plan of reorganization. It will be interesting to see if the secured creditors in *Philadelphia Newspapers* file a petition for *certiorari* with the Supreme Court, something that the secured noteholders in *Pacific Lumber* declined to do.

As a practical matter the implications of these decisions remain to be seen. For example, whether a secured creditor will be provided with the “indubitable equivalent” of its claim is a fact-based inquiry depending on the specific circumstances of each case. Indeed, both the Third Circuit and the Fifth Circuit made clear that in certain situations it may be necessary for the secured creditor to be given the right to credit bid in order for the plan to satisfy the

“indubitable equivalent” requirement. Although the Fifth Circuit decided that in the circumstances of *Pacific Lumber* the secured noteholders did not have to receive the right to credit bid in order to receive the “indubitable equivalent,” that issue remains open for the bankruptcy court to decide in *Philadelphia Newspapers*.

It is also possible, as Judge Ambro suggests, that the added risk to secured creditors created by these decisions will result in increasing the cost to borrowers of lending transactions at a time when the credit markets remain tight. Further, secured creditors may try to protect themselves by providing defensive debtor-in-possession financing with certain creative provisions relating to sales or plans of reorganization. Undoubtedly, these decisions likely will result in more contested confirmation hearings and litigation.

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